Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:UNY:TL-N-7201-99
RMBoulanger

date:

to: Chief, Examination Division, Upstate New York District
Attn: Barbara Zingaro, Revenue Agent
Thru: Machelle Smith, Group Manager 1308

from: District Counsel, Buffalo

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subject: **Audit - [redacted] and [redacted]**

DISCLOSURE STATEMENT

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ISSUE

This memorandum is in response to your November 19, 1999 memorandum for advice concerning the above-referenced audit. The issue presented is whether [redacted] can deduct [redacted] of its fee to [redacted] for so-called "failed merger work" as a loss under I.R.C. § 165.

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It is our position at this time that [redacted] may not take an abandonment loss under I.R.C. § 165 for work done regarding abandoned merger talks with other potential buyers or merger candidates.

FACTS

[redacted] entered into an agreement with [redacted] on [redacted]. [redacted] was hired to:

> [R]ender financial advisory and investment banking services to [redacted] in connection with the implementation of its strategy which may potentially include: I) the possible sale of the company or an interest in the company to another corporation or business entity (A buyer), which transaction (as sale transaction) might take the form of a merger of the company with, or sale of significant portion of its assets or more than 10% of its equity securities to, a buyer; and II) the possible acquisition (by merger, tender offer or otherwise) by the company (or subsidiary of the company) of another corporation (a seller) listed on attached Schedule A or the possible purchase by the company (or subsidiary of the company) of all or a significant portion of the assets of another corporation listed on the Schedule A (an acquisition transaction).

See, Confirmation Letter From [redacted] Dated [redacted]

[redacted] acquired [redacted] in [redacted] of [redacted]. The acquisition was stock for stock. [redacted] paid [redacted] $[redacted] for the successful merger with [redacted]. [redacted] deducted [redacted] of this fee claiming that it was for work done on unsuccessful mergers. The remaining portion was capitalized per a schedule M-1 adjustment and no amortization was claimed.

Synopsis of Services to be Provided by [redacted] As Set Forth on Pages 1-3 of Confirmation Letter

a. [redacted] will familiarize itself with the business, operations, properties, financial conditions and prospects of the company and any prospective buyer or seller.

b. [redacted] will advise and assist in developing a general strategy for accomplishing sale or acquisition transaction.

c. [redacted] will advise and assist in identifying potential buyers or sellers and will, on behalf of the company, contact such potential buyers or sellers.

d. In contemplation of a sale transaction, [redacted] will assist in preparing information materials for distribution to potential buyers.

e. [redacted] will advise and assist management in making presentations to the Board of Directors of the company concerning a general sale or acquisition strategy, any one or more potential buyers or sellers and any proposed sale or asset acquisition.

f. [redacted] will advise and assist the company in the negotiation of a sale or acquisition transaction with a potential buyer or seller.

g. [redacted] will render an opinion as to the fairness, from a financial point of view, to the shareholders of the company of the consideration to be received in a sales transaction or the consideration to be paid in an asset transaction.

h. [redacted] will render such other financial advisory and investment banking services as may, from time to time, be agreed upon.

Fees to be Paid as Set Forth on Page 3 of Confirmation Letter

a. $[redacted] upon execution of the letter;

b. $[redacted] contingent on and payable following the execution of a definitive agreement;

c. In the case of a sale or acquisition transaction, an additional fee equal to the sum of the following:

(i) [redacted]% of the aggregate consideration that is less than equal to $[redacted] and

(ii) [redacted]%% of the portion of the aggregate consideration that exceeds $[redacted] (less all amounts paid or payable under the immediately preceding clauses (a) and (b) with respect to such sale or acquisition

transaction), **such additional fee to be contingent upon the consummation of such sale or acquisition transaction and payable at the closing thereof.**

When [redacted] and [redacted] merged, [redacted] paid [redacted] the following fee:

Aggregate consideration of $[redacted] - Value of [redacted]'s shares exchange for [redacted]'s shares, plus preferred shares and debt less cash:

[redacted] X [redacted]%	=	[redacted]
([redacted] - [redacted]) X [redacted]%	=	[redacted]
EXPENSES		
LEGAL FEES		[redacted]
TOTAL		[redacted]

The $[redacted] and $[redacted] fee are not part of this issue. The treatment of this $[redacted] by the company is not known and the taxpayer has not provided an explanation. Your office may want to consider issuing IDR's to factually develop this aspect of the issue.

The taxpayer capitalized	$[redacted]
The taxpayer expenses	[redacted]
Total	$[redacted]

It is the taxpayer's position that the $[redacted] ([redacted] of the total paid) is deductible under I.R.C. § 165 for work purportedly done with regard to discussions with other potential buyers or merger candidates. However, a merger with these purported buyers was abandoned.

ANALYSIS

The issue in this case involved [redacted]'s assertion that it may deduct [redacted] of its financial advice, legal accounting, internal payroll, and other transaction costs, as a loss under section 165 of the Code. Taxpayer reasons that it abandoned merger transactions with other potential buyers when it was acquired by [redacted]. According to [redacted], this entitles it to deduct its expenses related to these "failed" transactions. It asserts that these expenses are [redacted] of all expenses related to the merger

transaction. For the reasons set forth below, an abandonment loss under I.R.C. § 165 is not allowable in these circumstances.

Section 165 of the code allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. To be deductible, a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and sustained during the year. Treas. Reg. § 1.165-1(b). Further, only a bona fide loss may be deducted. Substance and not mere form governs in determining a deductible loss.

Deductions for abandonment losses are not specified in I.R.C. § 165. However, Treas. Reg. § 1.165-2(a) provides that a loss is deductible under I.R.C. § 165(a) if it is incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein. Accordingly, merger and acquisition costs, otherwise capitalizable, are deductible losses under section 165 when the transaction is abandoned. Rev. Rul. 73-580, 1973-2 C.B. 86.

If a taxpayer engages in multiple separate and distinct transactions, costs properly allocated to abandoned transactions are deductible even if other transactions are completed. Sibley, Lindsay & Curr Co. v. Commissioner, 15 T.C. 106 (1950), acq. 1951-1 C.B. 3. Further, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. Tobacco Products Export Corp. v. Commissioner, 18 T.C. 1100, 1104 (1952); Portland Furniture Manufacturing Co. v. Commissioner, 30 B.T.A. 878 (1934); Doernbecher Manufacturing Co. v. Commissioner, 30 B.T.A. 973 (1934), acq. XIII-2 C.B.6, aff'd, 80 F.2d 573 (9th Cir. 1935). In short, these cases allow a deduction upon the abandonment of separate and distinct transactions even if subsequent or alternative independent transactions are pursued.

In contrast, if the proposals are alternatives, only one of which can be completed, no abandonment loss is proper unless the entire transaction is abandoned. Larsen v. Commissioner, 66 T.C. 478, 483 (1976) (costs of sale include costs of unsuccessful contacts). Thus, an abandonment loss is not allowable for proposals that are mutually exclusive alternative methods of reaching the desired goals. Ltr. Rul. 9402004.

In this case, [redacted] is claiming an abandonment loss deduction under I.R.C. § 165 for its costs associated with the purported potential purchasers who did not in fact buy [redacted]. Under Treas.

Reg. § 1.165-1(b), a deduction is allowable only if there is a closed and completed transaction. This means that taxpayer is allowed a deduction only if its negotiations with each potential purchaser constitute separate, concurrently viable transactions that are each closed and completed. This is a crucial factual question. Nicolazzi v. Commissioner, 79 T.C. 109 (1992).

The facts of this case demonstrate that taxpayer was not pursuing separate and distinct plans all of which could have been completed. Rather, finding potential buyers was part of the effort to accomplish a single transaction: the sale of [redacted].

[redacted]'s method of compensation further demonstrates that this is a single transaction. That compensation was a percentage of the total price ultimately obtained for [redacted].

In summary, the facts indicate one overriding plan; the sale of [redacted]. That plan was never abandoned. Rather, it was successfully completed with the sale of [redacted] to [redacted]. Accordingly, [redacted] is not entitled to claim a loss under I.R.C. § 165.

If you have any questions regarding the above, please contact Ray Boulanger of this office at 551-5610.

EDWARD D. FICKESS
Acting District Counsel